[2021] UKFTT 0056 (TC)

TC08042

CORPORATION TAX - settlement agreement in litigation - whether capital or revenue in nature revenue - appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2019/05095

BETWEEN

CHARLTON CHAUFFEUR DRIVE LIMITED **Appellant**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE ANNE SCOTT

The hearing took place on 18 February 2021. With the consent of the parties, the form of the hearing was the Tribunal video platform.

Having heard Mr Philip Simpson, QC, instructed by French Duncan LLP, for the Appellant

Mr Gary Cruddas, litigator of HM Revenue and Customs' Solicitor's Office, for the Respondents

DECISION

INTRODUCTION

1. This is an appeal against a Closure Notice issued on 19 March 2019 under paragraph 32, Schedule 18 of the Finance Act 1998 ("FA 1998") against the appellant for the year ending 31 December 2016.

2. The Closure Notice charged an additional £101,993.60 in tax.

Preliminary issue

3. The Settlement Agreement to which I refer hereinafter included confidentiality clauses relating to the appellant's auditor and former consultant accountant. For that reason the former is hereinafter referred to as ABC and the latter as DE.

The facts

4. The appellant traded under the name "The Booking Room" and provided international ground transportation services. It was a privately owned company with its head office in Glasgow. It ceased to trade on 31 December 2015.

5. The company's Chief Executive Officer and majority shareholder, Mr Michael O'Hare and the company's Group Financial Controller, Mr Ian Watt, became suspicious in early 2013 regarding the activities of the company's then Finance Manager, Ms Donna Shedden. She had been in their employment since 2003 when she had been employed as a bookkeeper.

6. Investigation of these irregularities brought to light that Ms Shedden had been embezzling money from the appellant for a number of years. The embezzlement had been carried out by a mix of methods, including

(a) taking money out of petty cash and putting in false claims for expenses or adding amounts to Mr O'Hare's director's loan account,

(b) Ms Shedden paying herself additional wages, and

(c) sending at least one customer a duplicate invoice.

It was estimated that the amounts embezzled from 2004 to 2012 were, in total, £773,701. In consequence of the appellant making deductions for corporation tax on the basis of the amounts embezzled, the appellant's loss in that period, after corporation tax, was £556,380.

7. Following discovery of the fraud, Ms Shedden resigned. She was prosecuted and, on pleading guilty, was sentenced to prison for four and a half years.

8. From 2001, DE was engaged by the appellant as a consultant accountant.

9. From 2007 until 2012, ABC were engaged by the appellant. ABC audited the appellant's accounts for the periods ending 31 December 2006 and 31 December 2007. ABC provided an accountant's report for each of the periods ending 31 May 2009 and 31 December 2009, but did not audit the appellant's accounts for those periods. ABC audited the appellant's accounts for the periods ending 31 December 2010 and 31 December 2011.

10. The appellant engaged Messrs KPMG to conduct forensic investigations into the embezzlement and the conduct of DE and ABC. KPMG produced a report in respect of each of them. Each report concluded that its subject had been negligent in performing their respective services to the appellant.

11. In the course of that investigation it was ascertained that Ms Shedden had arranged for payments totalling £726,269 to be paid by the company into her personal bank account during the period 1 January 2006 to 31 January 2013.

12. French Duncan were retained as auditors for all matters relating to the 2012 financial statements. In the course of preparing the 2012 financial statements, a prior year adjustment was necessary in order to retrospectively action the correct accounting treatment for the embezzlement. The correct treatment for employee defalcation is to expense the cost through the profit and loss account. The brought forward balance in the accounts was therefore reduced by the value of the embezzlement capitalised between 2004 and 2011 (£334,014).

13. In addition, further embezzled sums (£44,843) had been charged to the directors loan account in 2012. These were released to the profit and loss account in that period, detailed in the accounts as employee defalcations.

14. French Duncan amended the corporation tax return for 2011, which had been prepared by ABC, in order to capture the prior year adjustment arising from the 2012 financial statements. An additional corporation tax deduction was claimed in the sum of £334,014 which was in addition to the £60,118 which had already been expensed through the profit and loss account. The corporation tax return for 2012 included a claim for employee defalcations in the sum of £145,485 which included both the £44,843 reallocated from the balance sheet and a further £100,642 which had already been expensed through the profit and loss account.

15. Accordingly, all of the employee defalcations and all of the expenditure incurred in relation to that were deducted through the accounts and tax returns as business expenditure wholly and exclusively incurred for the purposes of the trade.

16. The appellant raised proceedings against DE and ABC to recover the loss it had suffered. The claims were based on (a) breach of contract and (b) fault and negligence. The sums sued for consisted of (a) £726,269 and (b) £89,865. These were the amounts that were, respectively, established and suspected to have been embezzled by Ms Shedden, and took into account a cap on ABC's liability and a small recovery made from Ms Shedden (£17,134.06).

17. The action was defended by both DE and ABC.

18. Various settlement discussions took place as the action progressed.

19. Ultimately, the action was settled. The parties entered into a formal settlement agreement, on 24 and 25 August 2016. In summary, the amount that was agreed to be paid by DE and ABC was in aggregate £566,000 ("the settlement"). That was without admission of liability. The agreement was in full and final settlement of all claims in the action, and all further claims of which the appellant ought reasonably to have been aware at the time. It was described as "settlement of the sums claimed". I set out the relevant provisions at paragraphs 25 and 26 below.

20. The settlement was paid in the appellant's accounting period ending 31 December 2016. The appellant's auditors, French Duncan, treated it as a capital receipt in the accounts for that period. They also treated the incidental expenditure in that accounting period as capital in nature.

21. On 27 September 2018, HMRC opened an enquiry into the appellant's corporation tax return for that period and by Closure Notice concluded that the appellant should bring the settlement into account as a trading receipt.

The pleadings in the Court of Session

22. In the Summons lodged in the Court of Session, paragraph 7 sets out the detail of the embezzlement and in particular states:-

"Analysis of banking records has disclosed that between 1 January 2006 and 31 January 2013 payments totalling £839,690 were made by the pursuer to DS. Valid wage payments account for £113,421 and the balance of £726,269 was unauthorised … The effect of the embezzlement by DS was to materially mis-state the pursuer's financial accounts for the years in question."

23. Under the heading "Quantification of the claim" the Summons states that:-

"As a result of the defenders' breaches of contract the pursuer has suffered loss and damage … Subject to that cap on the second defenders'(sic) liability, the total sum established as having been misappropriated from the pursuer's business is sought in the first conclusion …The sum suspected as also having formed part of DS's fraudulent activities is sought in the second conclusion…".

The first conclusion seeks payment of £726,269 plus interest and the second £89,865 plus interest. Of course, the appellant also sought the expenses of the action.

24. The third Plea-in-Law in the Summons states:-

"The pursuer having suffered loss and damage as a result of defenders' breach of contract and fault and negligence, is entitled to reparation therefor".

The Settlement Agreement

25. The preamble to the Settlement Agreement reads:-

"A. Court proceedings were raised in the Court of Session … against (i) [DE], … and (ii) [ABC] … as a result of losses sustained by Charlton further to sums being embezzled … between January 2006 and January 2013.

B. The Parties have agreed to settle the claim that Charlton has raised … under the Court Action.

C. The parties therefore wish to enter into a settlement agreement in respect of the settlement of the sums claimed by Charlton from [DE] and [ABC]."

26. The narrative of the terms of the settlement include the following:-

"1. [DE] and [ABC] will pay to Charlton the sum of **FIVE HUNDRED AND SIXTY SIX THOUSAND POUNDS** (£566,000) **STERLING** …

2. Payment … shall be without admission of liability and in full and final settlement of all claims for payment made in the Court Action.

3. Charlton releases and discharges [ABC] from all claims and liabilities of which they are or ought reasonably to be aware as at 29 July 2016 arising from the period Charlton appointed [ABC] in or around January 2007 to March 2013 and in respect of any, but not limited to, audit services, tax services and business advisory services provided, whether arising contractually, delictually or otherwise.

4. Charlton releases and discharges [DE] from all claims and liabilities of which they are or ought reasonably to be aware as at 29 July 2016 arising from the period during which [DE] was employed by Charlton as a consultant management accountant, whether arising contractually, delictually or otherwise."

21. The terms of the Settlement Agreement reflect the email discussions between the solicitors during negotiation of the settlement where it was clear that at all times the defenders were seeking decree of absolvitor and that the parties were concerned about the costs of litigation.

The arguments

27. The appellant argues that the settlement should be treated for corporation tax purposes as a capital receipt because it was received in exchange for its agreement to surrender a potential right of action against ABC and DE. Which failing it is argued that it should be treated as receipt of an after-tax amount and therefore it should not be brought into account as a trading receipt in any way.

28. HMRC argue that the settlement was to compensate the appellant for the loss of profits resulting from the embezzlement, which was undetected at the relevant time, and should correctly be treated as the receipt of the trade and revenue in nature.

Discussion

29. We heard evidence from Mr Michael O'Hare, Mr Stephen Hughes of French Duncan and Mr Kevin Marwein-Smith of HMRC. All were straightforward and credible witnesses. As I pointed out in the course of the hearing, to the extent that Mr Marwein-Smith expressed opinions, I agree with, and am bound by, Mrs Justice Proudman in *HMRC v Sunico*[1] at paragraph 29 where she states:

> "29. Accordingly, and in the absence of any expert evidence, much in this case turns upon my assessment of the documentary evidence in the light of the parties' respective analysis of it. As I have already noted, to the extent that the witnesses expressed their opinions on the documents they discussed I have discounted their evidence."

Accordingly, his opinions were discounted. The narrative of the facts by all three witnesses was uncontentious and simply expanded on the Agreed Statement of Facts.

30. I accept Mr O'Hare's evidence that the actual extent of the embezzlement was more extensive than the sums used in the criminal prosecution or indeed referred to in the Court of Session proceedings. Firstly, that is abundantly clear from the spreadsheet produced by Mr Lamb, the appellant's interim Finance Director, for Mr Marwein-Smith which encompassed the period 2004-2013 as opposed to the findings of KPMG, on which the litigation proceeded, and which covered the period 2006-2013. The latter produced a "provable" figure of £773,701. Mr O'Hare pointed out that the business had also received cash payments and that those were not traceable. I accept his assessment that although they had found a total of approximately £997,000 that could be attributed to embezzlement (and that was unchallenged by HMRC) the appellant had not litigated on that basis.

31. Whilst both parties agreed that the Tribunal must look to the reason for the settlement, HMRC focussed on the pleadings in the Court of Session and the appellant on the terms of the Settlement Agreement: hence my recital of the relevant paragraphs of both.

32. I find that it is the Settlement Agreement on which I must necessarily focus in the first instance since it is the primary source of the payment and the *sequitur* to the litigation.

33. I was not referred to any relevant law on the construction of the Settlement Agreement but as a specialist Tribunal I know it and I must apply it.

34. The Settlement Agreement falls to be construed according to the ordinary principles, and as Lord Fraser of Tulleybelton stated in *Aberdeen Construction Group Limited v IRC*[2] ("ACG") at 898 F-G that is "…not by looking at it specially from the point of view of …a taxpayer with a possible liability for tax".

[1] [2013] EWHC 941 (CH)
[2] [1978] AC 885

35. What then are the principles to be applied?

They are:

> (a) The Tribunal is concerned to identify the intention of the parties by reference to "what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean": Lord Hoffmann at paragraph 14 in *Chartbrook Ltd v Persimmon Homes Ltd*[3].
>
> (b) That exercise is carried out by focussing on the meaning of the relevant words in their documentary, factual and commercial context: Lord Neuberger at paragraph 15 in *Arnold v Britton*[4], who added that the meaning is to be assessed in light of
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> (i) The natural and ordinary meaning of the clause;
> (ii) Any other relevant provisions of the agreement;
> (iii) The overall purpose of the clause and the agreement;
> (iv) The facts and circumstances known or assumed by the parties at the time that the document was executed;
> (v) Commercial common sense;
> (vi) But disregarding evidence of subjective intentions.

36. The Settlement Agreement is very clear in its terms. It is very short. It reflects the negotiations. It covered more than the Court of Session litigation.

37. There was no acceptance of liability by the defenders. Their concern, as articulated by Clauses 3 and 4, was not only to settle the Court of Session litigation but to avoid the possibility of any further litigation and also to avoid any suggestion of liability. For the avoidance of doubt, I state that, not as evidence of their subjective intentions but, as evidence of the surrounding circumstances when, in popular parlance, the deal was done.

38. In summary, I accept that the appellant had taken a pragmatic approach to this litigation, in the face of a consistent approach by ABC denying any liability, and restricted the ambit of the claim (see paragraph 30 above). The appellant was seeking recompense for its losses. I also accept Mr O'Hare's clear and unchallenged evidence that the appellant was under financial pressure, unsurprisingly, and was worried about the soaring cost of litigation. The latter is borne out by the email correspondence relating to the settlement.

39. I am very well aware that two of the very relevant factors in the settlement of any litigation, or indeed any contentious matter, are the question of the costs and the impact on management time. I accept Mr O'Hare's evidence that that was the case here. There is also the uncertainty inherent in any litigation.

40. The fact that the settlement is within £380 of the figure of £566,380 described as "Gross loss to company" in the Master Reconciliation furnished by the appellant's interim Finance Director to HMRC is a mere, and irrelevant, diversion. It is absolutely clear from the negotiation emails that there is no science attached to the figure of £566,000: it was just a deal, and under pressure because it was a deal that was done just before the preparations for an expensive, and public, litigation moved to the next, and even more expensive, level.

41. It included all expenses in addition to the undertakings not to litigate on any other potential claims. The expenses, even on a party:party basis, let alone on an agent:client party paying basis would have been not insignificant.

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[3] [2009] UKHL 38
[4] [2015] UKSC 36

42. It is very clear to me that the settlement is precisely what I would expect in the commercial arena. I would have been wholly unsurprised if a lower and earlier offer on similar terms had been accepted.

43. Although undoubtedly the settlement included a surrender of rights to litigate, it was a decision commercially taken as being the best way to achieve an optimal recovery of the losses incurred with the least cost and risk.

44. Accordingly I do not accept the argument advanced for the appellant that the settlement was solely in exchange for a surrender of the right to litigate. At its highest that was simply an ancillary matter.

45. If, as I find, the settlement was compensation for the losses sustained by the appellant then was it a capital or a revenue receipt?

46. Both parties relied on *Roberts v W.S. Electronics Limited*[5], where Cross J stated that:

> "A question of this sort is not to be concluded by the way in which the parties choose to describe the payment in question. I must discover what the compensation in question – the £11,000 – was really paid for."

47. Accordingly, the fact that it was accounted for in the 2016 accounts as a capital receipt is not determinative.

48. Mr Simpson argued that none of the cases cited by HMRC were directly relevant to this case but relied instead on Lord Clyde in *Burmah Steamship Company v Inland Revenue*[6]. HMRC also relied on that.

49. In that very well-known case Lord Clyde drew a distinction between compensation filling a hole in a trader's profits and compensation filling a hole in a trader's assets, ie whether it is a revenue or a capital receipt turns on the nature of the "hole".

50. HMRC's argument was that patently the settlement related to the sums stolen, which would be profits, whereas Mr Simpson argued that it related to the extraction of a capital asset, namely cash.

51. Both parties also referenced Diplock LJ in *London & Thames Haven Oil Wharves Ltd v Attwooll*[7] where he stated:-

> "The question whether a sum of money received by a trader ought to be taken into account in computing the profits of gains arising in any year from his trade is one which ought to be susceptible of solution by applying rational criteria …
>
> I start by formulating what I believe to be the relevant rules. Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance, from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clause in a Charter-party or, or unliquidated

[5] 44 TC 525
[6] 16 TC 67
[7] 43 TC 491

from an obligation to pay damages for tort, as in the present case, from a statutory obligation or in any other way in which legal obligations arise."

52. The difference lies in the parties' approach to that quotation. Shortly put, HMRC argue that quite clearly the monies arose because they were profits that had been diverted and therefore they should be taxed as income and liable to corporation tax. But for the embezzlement they would have been.

53. By contrast, Mr Simpson argues that the case can be distinguished on the basis that in this instance there was no failure to receive money as in fact it had been the opposite. The monies had been received but had then been stolen. If they had not been stolen the money would have been recorded in the balance sheet as cash in hand.

54. Firstly, whilst that is what Mr Hughes said, that is speculation since, over the 12 years where embezzlement has been detected, no-one knows what the appellant would have done with any additional funds. The appellant might have used the monies for either capital or revenue expenditure or both or neither. Secondly, it is clear to me that, if there had been no embezzlement then (a) the monies that were diverted would have been reflected in the first instance in the profit and loss account in that there would have been no deductions for employee defalcations (and the associated incidental costs), and (b) it matters not where the monies end up, ie whether as cash in hand or used for various types of expenditure but rather how they got there.

55. Lastly, in the interests of completeness, HMRC relied on *Gray (HM Inspector of Taxes) v Lord Penrhyn*[8] ("Gray") where Findlay J stated in relation to the factual matrix that:

"Nothing particular turns upon the details, but it is a fact that the fraud was not discovered by the firm of chartered accountants who were responsible for auditing the accounts. No express admission of liability was made by the firm of chartered accountants, but it was admitted – we have looked at the correspondence – that a clerk, or clerks, of the firm of chartered accountants was, or were, negligent in not making inquiries which, if they had been made, would, in all probability, have revealed the fraud which was going on. Negotiations took place. There was, I should think, a probable – it is not necessary to say more than that – legal liability on the chartered accountants. Apart from that, it is perfectly apparent, for reasons which I need not go into, that the chartered accountants would not be anxious to have a case of this sort tried. Thereupon, an arrangement was made – it was not really a compromise – whereby the whole amount of the defalcations after the first audits – that is, the whole amount of the defalcations during the period for which the chartered accountants could be considered to be responsible – was repaid by the chartered accountants to Lord Penrhyn."

56. He went on to find:

"It seems to me that, looking at it from the point of view of the recipient, it is equally a business receipt, something which comes in in the course of the business. The substance of my view can be quite concisely put by saying that I think that there is a strong presumption that the two things, so to speak, balance; that is to say, looking at it first from the point of view of Lord Penrhyn, that since as an outgoing to these fraudulent people it was allowed, so, when that outgoing is made good, the thing ought to be cancelled out and that ought to be done, if not by the re-opening of previous years, then, as I prefer because it is simpler, by the bringing in of the receipt when it comes in. Looked at from the point of view of the chartered accountants and Lord Penrhyn, it

[8] 21 TC 52

seems to me that as the sum is an outgoing of the chartered accountants, so, looking at it from the other side, it is a receipt on the part of Lord Penrhyn.

57. HMRC argued that the detail was not relevant but in general terms *Gray* is on all fours with this appeal. Mr Simpson sought to distinguish *Gray* on the facts. I agree that the facts are not on all fours. However, I also observe that the tax treatment of the settlement for ABC and DE is not a matter that has been canvassed in any sense in this appeal. I do not find *Gray* to be of any assistance.

58. What matters is what "hole" there might be in this appeal and I find that the "hole" in this instance was a hole in the appellant's profits. It is therefore a receipt of the trade and revenue in nature.

59. I do not accept that it filled a post-tax hole. The sums that were stolen have never been taxed, indeed corporation tax deductions have been given for them.

60. Accordingly, for all these reasons, the appeal is dismissed and the Closure Notice upheld.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

61. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

ANNE SCOTT
TRIBUNAL JUDGE

RELEASE DATE: 01 MARCH 2021